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YUGOSLAVIA REMATCH WITH INFLATION

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DIRECTORATE OF INTELLIGENCE

Intelligence Memorandum

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CENTRAL INTELLIGENCE AGENCY
Directorate of Intelligence
January 1971

INTELLIGENCE MEMORANDUM

Yugoslavia In 1971: Rematch With Inflation

Introduction

Back in 1968, as the economy pulled out of the 1967 recession, Yugoslavia's leaders were as optimistic as ever that rapid growth could be sustained without inflation. By means of an alert monetary and credit policy, backed by the economic reforms of 1965, Yugoslavia would achieve a more rational and efficient structure of output and investment. Their hopes were echoed by the OECD report on Yugoslavia in November 1969: "there are reasons for believing that the beneficial effects of the reforms ... will make it possible to attain high rates of growth in 1969 and 1970 without undue strains on internal and external equilibrium."

Now the Yugoslavs are again struggling with serious inflation -- for the third time since 1960. During January-November 1970, the cost of living went up by 11%, and the hard currency trade deficit (about $940 million) rose 85% above the same period in 1969. Emergency controls, including a price freeze, were imposed at the end of October, and a three-stage stabilization program was drawn up for 1971. As happened in 1964, the planners have been sent back to the drawing board to redo the medium-term plan for 1971-75.

As before, inflation has given rise to demands for economic reform, including further institutional limits on federal spending. Moreover, Yugoslav problems now include not only economic but also political

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instability. In September, Tito announced that a collective presidency would be created to take over some of his domestic chores and eventually to succeed him. A major government reorganization is in progress, which involves more decentralization in favor of republics and local governments. These steps are designed to reduce the impact of growing regional economic and political conflict, especially after Tito.

This memorandum evaluates the causes and implications of Yugoslavia's chronic economic instability. In the short run, the government's task will be to stop inflation without provoking recession -- a maneuver at which the Yugoslavs have not been successful in the past. In the longer run, the problem will be to maintain economic stability in the face of increased political and economic decentralization.

Another Cycle

1. Inflation is an old story in Yugoslavia. It was present during the sustained boom of the 1950s even though the symptoms were merely suppressed by price and import controls. In the 1960s, when the government liberalized the economic system to promote greater efficiency, inflation and balance-of-payments problems occurred every time the economy grew faster than 10% a year.

2. Admittedly, external factors such as bad weather, "imported inflation," or foreign import controls often have contributed to instability. Then too, Yugoslavia's brand of inflation can be described in classic terms -- structural imbalances become more serious during periods of rapid growth, giving rise to excess demand for imports relative to export possibilities, and to excess demand for investment relative to financing possibilities. In addition, Yugoslavia has maintained a large defense budget and heavy social welfare expenditures. But behind it all has been Yugoslav economic policy -- dedicated to the competing objectives of promoting rapid growth and preventing instability, and increasingly unable to achieve either goal for very long.

3. Clearly, business cycles in Yugoslavia's mixed economy reflect stop-go policy cycles. The recession of 1961 essentially was touched off by a stagnation of exports, forcing the government to restrain demand by imposing stringent credit and import controls. In 1963, with recovery already well under way, the authorities saw fit to adopt a highly expansionary credit policy which led to inflation and the need for another round of rigid controls in 1964-65. The ensuing recession appeared to have bottomed out in 1966, but the government levied further credit controls to dry up remaining pockets of inflation, and the rate of industrial growth was driven down to zero. It seemed at this point that the government might be satisfied in the future with more moderate rates of growth. But recovery required another inflationary boost in credit, which together with rising government spending largely has engineered the present inflation.

4. The boom leading to the current crisis is summarized by the data in the table. Credit and monetary policy was loosened late in 1967 to bring the economy out of stagnation; the money supply and investment rose sharply, followed by a boom in industrial output and a spiral of prices, wages, and industrial imports -- particularly imports of raw and semifinished materials. Industrial producer prices rose by 9% in 11 months of 1970 -- the largest increase since at least 1952, except for years of price reform. At the same time, the hard currency trade deficit rose by 85% to a new high for the postwar period. The sharp rise in imports swamped the effects of a very large increase in Yugoslav industrial exports to hard currency areas and a continued increase in earnings from invisibles (tourism, transport, and workers' remittances).

5. On 29 October the government finally took emergency steps. A six-month freeze on all industrial prices was announced effective at midnight, and maximum prices were fixed for wheat, flour, sugar, fats, and rice. An obligatory advance deposit in dinars was introduced on imports contracted for after 29 October, amounting to 50% of the import value. Also, the limit on consumer credit was lowered from $800 to $480 per individual and a minimum deposit of 20% was required on all

Yugoslav Economic Instability

	Percentage Change				
	1967	1968	1969	1970	
Money supply	-2	24	12	21	a/
Socialized investment	-6	27	15	37	b/
Industrial output	0	6	11	8	c/
Industrial wages	10	10	15	15	d/
Industrial producer prices	2	0	3	9	c/
Cost of living	7	6	8	11	c/
Industrial imports	14	9	18	33	b/
Of which:					
Raw and semifinished materials	8	5	26	40	b/
Hard currency trade deficit	45	11	19	85	c/

a. September 1970 over September 1969.
b. Ten months.
c. Eleven months.
d. Nine months.

purchases. But why the delay? The economy already was getting out of hand in 1969, yet credit and investment continued to rise sharply throughout 1970.

6. One reason was that despite the boom in output in 1969 the economy was in a liquidity crisis. Many firms were producing and selling goods for which they were receiving delayed payment or even no payment at all. Weaker firms were putting a squeeze on even the most profitable enterprises. In addition, government funds earmarked for the economy were not arriving on schedule. An abrupt clampdown on credit in 1969 thus would have created more problems as well as provoking a good deal of criticism.

7. Even so, as will be discussed later, the government took a number of measures -- although feeble ones -- to brake the expansion between late

1968 and mid-1970. These proved ineffective and merely postponed the eventual showdown. Then, in mid-1970, the rate of industrial output began to slip, and the government probably expected in turn a slowdown in imports. Besides, exports were doing well and it may have seemed wise to delay drastic action.

8. What is more, the government was reluctant to admit that the economic reforms of 1965-67 were already in need of major repairs. Basically, as some Yugoslav economists began to point out, corrections were needed not so much in economic institutions as in federal economic policy. One of these economists, Branko Horvat, stated in October 1970 that "the basis of our economic troubles lies in the insufficiently thought-out, improvised, and often wrong economic policy." Economic decentralization has not been accompanied by the creation of appropriate short-term economic controls. Equally important, although less frequently mentioned by Yugoslavs, the government has not been able to resist pushing for very rapid rates of growth.

<u>Decentralization and Economic Control</u>

9. It is clear that Yugoslav economic fluctuations became more violent as the economy became freer in the 1960s. A common verdict is that decentralization has been good for efficiency, bad for stability.

10. Decentralization has given enterprises control over what to produce, whether to sell at home or abroad, and how to distribute net income between investment and wages. The commodity market was allowed varying degrees of freedom in the 1960s -- over one-half of the value of industrial output was being produced under free prices before the latest price freeze.

11. There is, however, only a rudimentary capital market. Banks have been given substantial control over investment resources, but the creation of a capital market in the normal sense has not been attempted -- the effective interest rate in capital-poor Yugoslavia would be very high. In addition, regional self-interest has hampered the

mobility of capital through the banking system. Nor has a market been established for channeling foreign exchange throughout the economy. Instead, there is an elaborate foreign exchange system that leaves some exchange with those who earn it, and makes some freely available at the banks for certain imports, but otherwise imposes a number of controls, defining which firms can buy how much of what goods from whom.

12. Even labor is not effectively allocated by market forces. The influence of workers' councils tends to discourage firms from letting workers go, or taking them on. Substantial unemployment now exists, and interregional migration is low -- workers remain in marginal enterprises in spite of low wages.

13. Such an economy -- with weak market forces and strong market barriers -- understandably presents major problems of control. The government's solution, except in crisis periods, has been an almost exclusive reliance on credit controls and an ad hoc monetary policy, involving expansion and contraction of the money supply through changes in bank reserve requirements, through rediscount ceilings, and through selective controls on credits for imports, investments, and personal consumption. In addition, the government has tinkered with import controls, including changes in foreign exchange regulations and import surcharges. Fiscal policies, particularly progressive taxes on profit and income, have been largely ignored, partly in the interest of obtaining steady government revenues. An incomes policy -- tying wages to productivity -- also has been absent since the early 1960s. And, of course, interest rate manipulation has not been relied upon as a counter-cyclical device.

14. As a result, government policy in the 1960s has contained no built-in stabilizers. Policy has been discretionary, and it has run into the familiar problem of producing delayed effects. Moreover, as illustrated by the experience of the 1960s, Yugoslav enterprises, banks, and trade organizations have been highly insensitive to moderate changes in economic policy, particularly during boom periods. It has taken a major credit squeeze to dampen demand and a major credit expansion to

get the economy moving again toward planned rates of growth. During the recent upswing, for example, the government made repeated attempts to regulate demand. In late 1968, the compulsory reserve ratio for commercial banks was raised from 25% to 30% and the rediscount ceiling (the share of these reserves that can be rediscounted) was lowered from 20% to 15%. In March 1969, the reserve ratio was lifted to 32%, and a 20% cash downpayment was required of consumers using bank credit. In the summer of 1969, the reserve ratio was lowered to 30% because bank liquidity was dangerously low. In May-July 1970, however, the ratio was pushed back to 32% and the rediscount limit was dropped to 12% because of the continued inflationary increase in the money supply. Also in July, the government added controls on public spending and a 5% surcharge on imports. None of these efforts had any effect, least of all the small import surcharge, which was greeted by huge increases in hard currency imports in the last half of 1970.

Why Rapid Growth?

15. It may be that if a counter-cyclical fiscal policy and an incomes policy had been added to the arsenal, the battle for stability would have run more smoothly in the 1960s. The chances would have been better, however, if the government had set its growth sights lower. Economic plans, including the latest medium-term plan for 1966-70, consistently have called for annual rates of industrial growth of 10% or higher. Even the original version of the 1971-75 plan called for a 9%-10% rate. As in other less developed countries, there are few if any Yugoslavs who support lower rates of output. One reason is the desire to reach the West European standard of living. But another, increasingly compelling, argument is the desire to narrow the regional income gap in Yugoslavia.

16. The regional case for rapid growth can be illustrated by comparing the rates of growth needed by Kosovo -- Yugoslavia's most backward region -- to reach the Yugoslav average per capita national income. If Yugoslavia's average per capita rate of growth were only 3% per year over the next 20 years, Kosovo would need a 9% rate to close the gap. Such a spread would be impossible

with any semblance of a uniform policy and a united market in Yugoslavia. If Yugoslavia grew at 9% a year, Kosovo would require a rate of 15.4% -- a spread which at least is closer to being feasible. Of course, if a much longer time horizon were politically possible -- say 40 years -- a smaller difference in growth rates would be required to equalize per capita national income. According to the initial regional plans for 1971-75, Kosovo's national income was to grow at a per capita rate of roughly 10.6% compared with a national average of about 6.7%. If these rates could be achieved and maintained, it would take some 30 years to close the gap.

17. Rapid growth nevertheless has not had the desired effect. Even during the sustained boom of the 1950s, the gap between richer and poorer republics widened.* And in the 1960s the less developed regions began to lose ground more rapidly. On one hand, the new emphasis on economic efficiency after 1965 tended to favor the more developed northern economies. On the other hand, the destabilizing effects of the government's stop-go policies were felt much more strongly in the poorer regions -- production slipped further and recovered more slowly in most of these areas during 1967-68.

18. Yugoslav policy since the mid-1960s has shifted partly away from the growth-for-its-own-sake philosophy of the 1950s. As shown by the deep recession of 1967, the government has been willing to sacrifice rapid growth to control inflation, and it has tried to retain a decentralized system to promote efficiency. And yet, rather than settle for moderate rates of growth, the leadership still is searching for a formula that will yield rapid but stable growth. As in past inflations, the current crisis has produced a rash of new economic proposals, some geared to stabilizing the economy and others focused on sustaining growth without inflation in the future.

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* *The less developed regions are Bosnia-Hercegovina, Macedonia, Montenegro, and Kosovo; the most developed are Slovenia and Croatia. Serbia and the autonomous province of Vojvodina are about at the Yugoslav average per capita income.*

New Proposals

19. The emergency steps taken in October 1970 were to provide a breathing space to allow the government to prepare a broader package of stabilization measures. On 26 November, Mitja Ribicic, the President of the Federal Executive Council, outlined a three-stage program.

20. The first stage stresses immediate measures to reduce government budgetary and non-budgetary spending and to restrain imports. A freeze will be imposed on federal, republic, and local government revenues that exceed an increase of 10.8% in 1971. The excess would be held in reserve and reportedly would eventually be returned in some way to the economy. Budget surpluses are already frozen and it is proposed to extend the freeze until the end of 1971. In addition, the federal tax on personal incomes paid by enterprises is to be reduced from 2.7% to 2%. This will cut annual federal revenue by 600 million dinars ($48 million). The current deposit requirement for imports, already reduced from 50% to 30%, is to be replaced by foreign exchange and other import controls. These measures were not clearly spelled out. So far the leadership has indicated that foreign currency expenditures by government and other institutions which receive allowances from the central foreign exchange fund will be reduced by 20% in 1971.

21. The second stage -- planned to be introduced early in 1971 -- will contain basic changes in the economic system, including a further redistribution of income in favor of enterprises. According to Ribicic, the economic functions of the federal government are to be restricted to the measures necessary to ensure a united Yugoslav market and to carry out foreign economic policy. This will mean a substantial reduction in the federal budget, and new solutions will be proposed for supporting the development of backward areas, crediting exports of equipment, and even financing the national defense. The federal government will not bow out of these areas, but the federal budget reportedly is to be confined to administrative expenditures which amount to about 1% of Yugoslavia's annual national income. The second stage also is to include changes in the tax, credit, and foreign

exchange system. In addition, Ribicic asserts that the government has "begun to seek solutions regarding fiscal policies" and that "the stabilization program necessarily demands a more definite policy of income and personal incomes." Proposals to fill these gaps in Yugoslav policy may also be part of the package presented early in 1971.

22. Additional measures will be introduced in the third stage as part of the belated 1971-75 plan, now scheduled for April 1971. By this time, proposals concerning the new collective presidency and the related government reorganization would be taking shape -- possibly requiring new steps to dovetail the economic and political systems.

23. The new stabilization proposals have provoked considerable criticism, even though the appropriate government organs have publicly endorsed them. Most disturbing was the resignation of Nikola Miljanic, one of the three vice presidents of the Federal Executive Council, a prominent financial expert, the author of past stabilization programs, and a Croat delegate to the Chamber of Nationalities. His resignation statement revealed a dispute with Ribicic over the sequence of measures adopted in the stabilization program -- a sequence which in his words "would produce effects for which I am not willing to bear personal responsibility ... ." The main issue was reported to be the postponement by Ribicic of foreign exchange devaluation which, as Tito has said, must come eventually but not first.

24. A more sweeping indictment came from another Croat delegate to the Chamber of Nationalities, Kresimir Dzeba, who called the program inadequate, and proposed a special commission of inquiry to look into inaccurate data and misleading economic assessments put out by the federal government. The most common complaint, however, was that the proposals were hazy. As one federal deputy put it, he would vote for the measures but with his "eyes half closed" because he had no idea of what they would do.

Short-Run Effects

25. The leadership itself undoubtedly is not certain what effect the new program will have. At

the moment, the government seems to be working as hard to keep the economy moving as it is to combat inflation. Fear of recession has dictated a gradual approach; equilibrium in the domestic market and in the balance of payments is not expected until 1972. For 1971, the government is projecting a 5.5% rise in industrial output, hoping that the reduction in taxes and a drop in the obligatory advance deposit on imports to 20% in January will buoy enterprises enough to avoid stagnation. Even the measures to cut government spending are far from drastic -- the 10.8% maximum increase of government spending is double the projected 5% to 5.5% increase in the national product in 1971.

26. Stronger measures may prove to be necessary. Imports continued to rise rapidly in November 1970, suggesting that it might take some time for import controls to bite and for the current slowdown in industrial output to dampen import demand. On the other hand, exports fell by 6% in October compared with the same month in 1969 and grew by only 2% in November. If this trend continues, harsher controls may be needed on imports. Moreover, the government knows it cannot maintain the price freeze indefinitely -- it would merely aggravate an already distorted price and cost structure. More stringent controls on investment and consumer spending together with another price reform and devaluation may be introduced in April 1971 when the freeze is scheduled to be lifted. Under these circumstances, there is a real danger of recession before the end of 1971.

The Longer Run

27. Although the government has accepted a lower rate of growth in 1971, the new economic proposals do not necessarily herald a basic change in the government's approach to growth. Indeed, once the current adjustment period is over, the government is likely to resume the push for high rates of growth. And unless the proposed changes in the economic system somehow bolster the government's short-term economic policy, the long run, as in the past, is likely to be a series of sharp short-run fluctuations.

28. Economic control may be made even more difficult as a result of the impending government reorganization. Details have not yet been worked out, but the rough blueprint calls for a collective presidency with equal representation from the republics. The chairman or president of this body would be elected for a short term -- perhaps a year -- and this office would be passed in turn among the republics. Changes in the constitution also are being prepared which are to include more precise definitions of the economic functions of the federal and republican governments. In effect, these will ratify current proposals to reduce the direct role of the federal government in financing economic development, and to consolidate what is left of federal power to control the economy.

29. In principle, the effectiveness of federal economic policy is supposed to be strengthened -- not weakened -- by the reorganization. Banks and enterprises -- not republican governments -- are supposed to fill most of the vacuum created by reduced direct federal spending. And the republics are to delegate full authority to the new federal leadership to control the domestic market and the balance of payments. The intent is to avoid replacing federal centralism with republic centralism.

30. In practice, however, the republics are bound to gain a good deal of economic autonomy from the reorganization. According to a group of Croat businessmen, the republican government, at least in Croatia, already influences nearly all bank credits for investment. Now the republics will have a more direct voice in federal economic policy through their representatives in the new collective leadership. This arrangement adds another layer to the problem of economic control. It has already been difficult for federal policy measures to provoke the right response from enterprises and banks. Now, to the extent the new presidium becomes a sounding board for competing regional interests, it will be more difficult to adopt the strong, often unpopular, policy measures that are needed to avoid inflation and balance-of-payments difficulties. The north will continue to press for easy credit to develop exports and tourism, insisting on the right to retain foreign exchange earnings. The south will continue to press for industrial development credits, insisting on allocations of foreign exchange for

increased imports. Added up, regional demands for rapid growth still spell inflation.

31. Another result of the changes in the system may be to shift the main trouble spot from investment and government spending to personal incomes. Now that firms and banks will have added resources, and the government presumably will keep the lid on investment credits for a year or so, enterprises may be disposed to give in to worker demands for large pay boosts. In the past, most Yugoslav officials put most of the blame for inflation on investment spending. A number of well known economists, however, such as Aleksandar Bajt and Branko Horvat, have recently criticized the government for ignoring the effect of personal incomes on inflation. At a recent conference of economists, Bajt stated that it was precisely "the system of income" that was giving birth to inflation, and Horvat called for income controls as a primary means of controlling prices. Neither, however, seemed to feel that the government was about to adopt a strong incomes policy. As Bajt was speaking, someone in the audience remarked that those who were against income controls were not present at the conference. Bajt shot back: "Yes, they are probably preparing that stabilization program." This criticism may have had some result. On 29 December, after steadfastly maintaining that there would be no emergency wage freeze, the government announced that wages on the average would be limited to an 11% increase until April 1971. Although not a very restrictive measure, it at least indicates that the leadership is concerned about the impact of wages on inflation.

32. Tito undoubtedly will guide the operation of the new presidency. He will be given a special seat of leadership under the constitution. He has implied, however, that the new government leadership will function under its own steam as far as domestic affairs are concerned while he will devote his time to foreign affairs. Although a true test of collective leadership will not be possible until Tito is gone, much will depend on how well the economy performs in the next five-year plan period. Another serious bout with inflation, another failure of medium-term planning, and the next round of reform could just as likely include some economic recentralization as a further dose of decentralization.

Conclusions

33. Chronic inflation in Yugoslavia always seems to put the economy at a critical juncture -- raising the fear that the next crisis will mean a return to central plan directives. But the danger of this is remote. The Yugoslavs are perhaps frustrated, but not disillusioned by the failure of their efforts to sustain stable growth rates in a decentralized economy. Indeed, in the 1960s the leadership reacted to economic instability with more decentralization. If inflation has a bright side, it is that it shows the regime has gone remarkably far in liberalizing the economic system.

34. What the regime has not been able to do is reconcile its political commitment to the poorer regions with the pursuit of a policy of moderate growth, more in line with the economy's capacity to increase investment and exports. A rate of growth high enough to show visible progress in the poorer regions has involved an unacceptable rate of inflation. Moreover, the government so far has tried to maintain its commitment to the less developed -- and to economic decentralization -- without employing a full range of short-term controls, including a concrete incomes policy and so-called automatic stabilizers such as progressive taxes and counter-cyclical budget spending by republics and the federation.

35. There is little prospect for a basic change in the government's approach to economic growth. However, there is a new urgency on the part of the federal leadership to find politically acceptable solutions to the problem of economic control. The government at least is talking about fiscal policies, and the limited wage freeze announced in December 1970 may indicate that the leaders will oppose the worker councils and trade unions on the question of a permanent incomes policy. Even so, the faster the rate of growth, the more prepared the government must be to step in with emergency controls on prices and imports. And even this will likely be more difficult under the proposed collective leadership which will give republics a more direct voice in formulating Yugoslav economic policy. The less timely the government's reaction to inflationary

crises, the harsher the direct controls will have to be -- to the detriment of market forces.

36. The return of inflation so soon after the last economic reforms has taken some of the optimism out of the leadership. Past reforms have come through to the people as basic solutions to the problem of economic instability, even though the leadership has warned that overnight results could not be expected. By now the Yugoslavs must be skeptical. In the future, the government may have to take a page out of the Hungarian reform program and begin presenting their economic promises to the public in a more realistic, less rosy light.